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JAPAN PONDERS FREE TRADE PACTS: BUILDING BLOCKS OR ROAD BLOCKS?

Summary

Free trade is an idea advocated by most industrialized nations, including Japan, although the current global trading regime is far from that ideal. As talks proceed on a new round of multilateral trade liberalization under the General Agreement on Tariffs and Trade, two other events have given new life to the dream of free trade. The European Community's plan to eliminate the remaining intermember barriers to trade beginning in 1992 and the U.S.-Canada Free Trade Agreement have generated both hope and concern with respect to global free trade. Since the EC and the United States account for a large share of global and Japanese trade, Japan is naturally interested in these developments. Not only have these two events provoked policy responses from Japanese officials and businessmen but they have stimulated an intellectual debate as well.

Introduction

The proposition that free trade yields benefits has been the basis of America's postwar trade policy and a position that most other industrialized nations have adopted. Several rounds of tariff reductions negotiated under the auspices of the General Agreement on Tariffs and Trade have led to a growing volume of international trade, which has raised standards of living and promoted industrial efficiency. Notable exceptions to free trade still exist, however. Trade in agricultural products, textiles, steel, cars and many other consumer goods and services are subject to controls imposed by governments unilaterally, multilaterally or "voluntarily."

When an upsurge of economic nationalism caused by large trade imbalances in the 1980s combined with a realignment of the relative economic strengths of the United States, Japan and West Germany, pressures increased for managed trade, the regulation of commerce through nonmarket mechanisms. These pressures actually have been magnified by the success of previous GATT-negotiated tariff reductions. As average rates fell, tariffs lost their deterrent value. Governments that feel vulnerable to dumping or other "unfair" practices of their trading partners have sought to supplement statutory tariff structures. Antidumping and other trade laws thus have come into wider use -- the Omnibus Trade and Competitiveness Act of 1988, for example. Since these laws are developed and applied unilaterally, other countries feel the need to respond with similar rules, potentially impinging on free trade.

To counteract this trend, GATT's 96 members initiated in 1986 a new round of negotiations, known as the Uruguay Round, to broaden the scope of the international trade organization's liberalizing influence to areas such as agricultural trade, financial transactions and intellectual property rights. Progress is being made, but its ultimate success is still in doubt (negotiations alone could take up to 10 years). Even if successful, it will be many years before the full impact of any agreement is felt.

Partly out of frustration with GATT's lengthy process, the Reagan administration has negotiated two bilateral free trade agreements: one with Israel in 1985 and the other with Canada, an as-yet unratified agreement finalized in October 1987. The agreements are seen as carrot and stick tools vis-a-vis the GATT process. On the one hand, they show that free trade pacts covering new or contentious areas can be negotiated, serving as a model for the GATT talks. On the other hand, they serve as a warning to GATT members that the United States is willing and able to pursue bilateral liberalization if the multilateral process stalls. While similar in impact, the European Community's plans for 1992 arise from an entirely different background.

Worked out in 1985, the EC plans are a natural evolution of the common market concept. Having already eliminated tariffs and quotas among members and established a common external tariff structure, the community is addressing the remaining barriers to trade and the movement of labor and capital. Efforts include harmonizing financial regulations as well as industrial, agricultural and health standards and certification requirements. Other impediments to the free flow of goods, such as customs clearance procedures, also are targeted. Regulation of services, such as airlines and communications, will be reduced and unified. Licenses or accreditation for professional services will be recognized within the community on a reciprocal basis. If the process is successful (1992 is only the start), the EC will become the largest single market in the world with a population of 320 million and a gross domestic product of around $4.4 trillion, according to the Organization for Economic Cooperation and Development.

Japan cannot but take notice of these developments. Trade with the United States and Canada accounts for one-fourth to one-third of its total exports and imports (see Table). While transactions with North America as a

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share of the total have declined slightly since 1986, trade with the European Community is on the upswing. Japanese foreign direct investment in both areas also is surging (see JEI Report No. 23B, June 17, 1988), just as financial linkages are expanding among the London, New York and Tokyo markets (see JEI Report No. 35A, September 16, 1988). It comes as no surprise, therefore, that Japanese businessmen, politicians and bureaucrats are fashioning responses to proposed changes in these key markets.

Japan's Trade with the United States, Canada and the European Community

(share of Japan's total exports or imports in yen terms)

	Canada		United States		European Community	
Year	Exports	Imports	Exports	Imports	Exports	Imports
1980	1.9%	3.4%	24.2%	17.4%	12.8%	5.6%
1981	2.2	3.1	25.5	17.6	12.4	6.0
1982	2.1	3.4	26.2	18.3	12.3	5.7
1983	2.5	3.5	29.2	19.5	12.6	6.4
1984	2.5	3.6	35.3	19.7	11.4	6.8
1985	2.6	3.7	37.1	20.0	11.4	6.8
1986	2.6	3.8	38.4	22.8	14.7	10.9
1987	2.5	4.1	36.5	21.1	16.5	11.8
1988: I-III	2.5	4.5	33.5	22.4	18.1	12.8

Source: Ministry of Finance.

European Integration in 1992

The EC's plans for 1992 have caused the most concern in Japan, in part because many policies with regard to non-EC members have yet to be clarified and because bilateral relations have been focused narrowly on trade. Japan-EC relations have always ranked well behind both sides' ties with the United States, although the relative increase in bilateral trade is beginning to change this. Both the United States and Japan are concerned that the EC will try to ensure that virtually all the benefits of integration accrue to European firms by establishing special rules for foreign firms.

Trade Policy - More than a dozen Japanese exports currently are monitored by agreement, including cars, videocassette recorders and other consumer and industrial goods. In addition, some EC members have individual restrictions. France, for example, limits Japanese car sales to 3 percent of its market. Italy has even tighter quantitative restrictions on imports of Japanese vehicles. Integration should erase these various national policies and replace them with a single regime. Tokyo has expressed concern that the replacement will be worse than what currently exists, as EC members most at risk have argued strongly for stringent common controls on Japanese-made imports. At the least, the EC is likely to impose what it calls transitional measures to moderate the impact of any changes. Until the community makes up its collective mind on exactly what it will do (cars could prove particularly difficult), Tokyo can only reiterate its support for free trade.

The EC's antidumping rules, which have been a source of friction in the past, also pose a maze for integration changes. Tokyo has complained about the EC's methods of determining if dumping has occurred and about the application of antidumping penalties to goods assembled in the community with imported parts. This crackdown on what the EC terms "screwdriver" plants has implications beyond trade in parts and subassemblies since it could have a chilling effect on foreign direct investment in the community, something the EC has been trying to promote.

Direct Investment - In addition to the dumping issue, a current dispute between Paris and London over cars produced in Britain by Nissan Motor Co., Ltd. has cast an even darker shadow on Japan's foreign direct investment in Europe. The vehicles currently have a British content of 60 percent, and Nissan officials predict this will rise to 70 percent in the near future. Nissan wants to ship some of the British-built vehicles to France, but Paris is insisting that the local content must reach 80 percent before it will classify the cars as British and exempt them from its quotas on Japanese cars. London is furious since recent EC practice has been to use 60 percent local content as the dividing line between domestic and imported goods. France points out that the language used in previous instances only states that a "substantial portion" must be locally procured. Paris therefore feels it has leeway to determine what is "substantial." The EC Commission is likely to come down on Britain's side, but this still leaves the question without a definitive answer.

Japanese businessmen are voicing their frustration with the EC's policies. On the one hand, foreign direct investment is welcome. On the other hand, stiff antidumping penalties and local content requirements make it very difficult to operate. Japanese firms have consistently stated their commitment to increasing local procurement of parts as quickly as possible and to investing in Europe for the long term.

Even if the EC continues to complicate the foreign direct investment issue leading up to 1992, it is unlikely that the flow of Japanese investment will decline for several reasons. First, the EC has hinted strongly that foreign firms with a presence in Europe prior to 1992 will receive equal treatment with domestic companies. Many Japanese businesses, especially medium-sized ones, therefore are rushing to establish a beachhead in advance of 1992. There may be some contention over what constitutes a sufficient presence, but so far the EC has set no guidelines. Second, the appreciation of the yen has made overseas production a key part of Japanese business plans. Local production can offer other benefits besides relatively lower costs: the response time is faster when local tastes change and services, such as just-in-time delivery, are more easily offered. Direct investment in the EC is not a panacea, however, particularly when it comes to financial services.

Services - Alarm bells went off in Washington and Tokyo when the EC began using the term "reciprocity" in regard to the activities of foreign firms within the community after 1992. The statement seemed to imply that foreign access or operations would somehow be restricted unless foreign governments provide EC firms with the same freedom of action in their markets as foreign firms would have in Europe. Reciprocity is of particular concern to Japan and the United States in regard to financial services since both countries -- contrary to European practice -- separate commercial from investment banking in their domestic financial markets. The obvious worry is that multinational Japanese

and American financial firms will force Tokyo and Washington to rashly deregulate their domestic markets in order to assure full access to Europe's financial arena.

The policy is so vague that member governments have protested to the European Commission that more clarity is needed if Europe's money markets, which have grown strong thanks to comparatively few restrictions, are to prosper. After reviewing the current reciprocity proposal contained in a draft of the Second Banking Coordination Directive, British and West German finance ministers led a campaign to ensure that the directive will be GATT-compatible. The ministers want "mutual availability of opportunities" that also will conform to the current round of GATT negotiations on financial services. It is uncertain, however, whether acceptable language can be found before the informal deadline of the end of this year. If not, then the mid-1989 date for adopting the directive will have to be pushed back, and uncertainty will continue to cloud the picture.

Japanese firms in other services fields also are examining new strategies to cope with the effects of integration, although the uncertainty factor complicates planning. Shipping companies are accelerating efforts already under way to link up with European partners and form new groupings. Japanese airlines, still struggling under intense domestic regulation, are giving a lower priority to the situation. Insurance and other business support companies are investigating the costs and the requirements of setting up shop in Europe, but no stampede is developing.

In sum, the Japanese response to 1992 is to get a foot in the door through direct investment. Participation in the merger and acquisition boom that is sweeping the continent also is a possibility. At the official level, Tokyo will continue to apply pressure along with the United States to forestall the creation of "fortress Europe." The final outcome of integration is not at all clear, given the contradictory statements by EC officials on keeping the market open while trying to assure a "balance of benefits" between foreign and domestic companies.

U.S.-Canada Free Trade Agreement

In comparison to the frenzied Japanese response to 1992, Japan's reaction to the U.S.-Canada Free Trade Agreement is almost nonchalant. This is mainly because the pact, which still must be ratified by Canada, does not contain major provisions directed specifically at foreign companies; it does not seek assurances of reciprocity from foreign firms that might benefit from the agreement. Instead, the agreement seeks to guarantee access to each other's market, indirectly granting the same assurance to foreign firms through their American and Canadian subsidiaries. Because both the United States and Canada adhere to the philosophy of national treatment for foreign firms in practically all areas of regulation and because the trade pact would not change this, Japan feels confident that its access to the two countries would not be reduced.

In fact, most Japanese businesses are confident that they would benefit to some degree from the pact. Exports of capital goods may rise as U.S. and Canadian firms gear up to service the enlarged market. Financial firms, which already have a firm foothold in the United States, would benefit from improved access to the Canadian market. Japanese direct investment would receive a boost from the pact, just as American and Canadian cross investment is expected to benefit from the more stable economic environment.

There could be some small drawbacks to the pact for Japan, however. The most significant one would end the Canadian practice of rebating import duties paid on cars and parts that are re-exported to the United States. If the pact is approved, Canada must end duty remissions on exports to the United States on January 1, 1989 and gradually phase out all other rebate programs. Given the growing Japanese automotive manufacturing base in the United States, this is not of great concern to the Japanese.

Since many Japanese manufacturing and service firms already have a presence in the United States or Canada, there is no direct investment frenzy as there is toward Europe. Since the U.S.-Canada FTA does not seek to win concessions from foreigners in exchange for access to the combined market and because its terms are clear and unambiguous, Japan feels confident that the FTA would lead to a net gain for the United States, Canada and itself. Japanese businesses see little need to change strategies for penetrating the U.S. or Canadian markets, and Tokyo sees no reason to oppose the agreement. On the contrary, the pact has generated interest in a U.S.-Japan free trade agreement and revitalized the concept of a Pacific Basin trade zone.

A U.S.-Japan Free Trade Pact?

Beyond the immediate stimulus of the EC's 1992 integration plan and the U.S.-Canada FTA, a number of other forces are promoting debate on a U.S.-Japan FTA. It is clear to both sides that trade frictions are never going to disappear and that they may increase as the level of technological competition between the two nations intensifies and as governments focus on politically sensitive areas such as agricultural trade. Although no trade issue presents a major threat to smooth overall bilateral relations at the moment, there is no guarantee that this will last. A bilateral FTA promises to remove major irritants and create a more stable and positive economic environment by guaranteeing both sides mutual access to each other's market and ameliorating the capricious impact of trade laws.

Even in the past when a trade dispute was settled, the solution was often politically acceptable but economically less than optimal. Japanese policymakers and businessmen are very interested in the institutions set up to manage the U.S.-Canada pact: the Canada-United States Trade Commission and the joint dispute settlement panels that will arbitrate problems the commission cannot solve. If these institutions prove to be apolitical and capable of handling tough trade issues, the Japanese probably would welcome inclusion of similar institutions as part of a deal with the United States.

From an overall standpoint, both the United States and Japan see a need to restructure the bilateral relationship to reflect a new balance of economic power. The old paradigm of U.S. demand/Japanese response often has added to tensions, a trend that easily could increase as Japan asserts itself in global affairs. A bilateral, or better still, a Pacific free trade zone could serve as a solid foundation on which to build a new relationship.

One indicator of how seriously the idea is being taken is the number of studies and proposals it has generated. So far, one U.S. government agency has studied the matter, and one piece of legislation has been proposed. On the other side of the Pacific, three agencies have launched formal studies of a free trade arrangement and two others are discussing it informally.

United States - At the request of the Senate Finance Committee, the International Trade Commission issued an overview of the pros and the cons of a bilateral FTA (see JEI Report No. 37B, September 30, 1988). The report, which was assembled in only three months, takes a "kitchen sink" approach by listing many possibilities and alternatives. Briefly, the report lists the following as the major U.S. advantages of a bilateral free trade area:

- Improvement of the political atmosphere for negotiations with Japan. It would give formal recognition to the already substantial economic relationship between the United States and Japan. It would elevate U.S.-Japan trade policy to a status equal to military and political concerns. It also would improve the trade atmosphere because the forum, goals and timetables would be mutually agreed on. And it would create less confrontational and regular dispute settlement mechanisms to resolve problems prior to the U.S. side resorting to Section 301 of the 1974 Trade Act or either side tapping the GATT resolution process.

- Enhancement of the U.S. ability to achieve trade objectives. The United States would be compelled to reassess its trade goals with Japan and establish clear priorities. An FTA would provide a better mechanism for identifying and addressing remaining systemic Japanese trade barriers, such as the distribution system. It would enhance U.S. leverage by providing a major incentive for the Japanese to cooperate. It also would provide a forum for developing rules in areas such as services, investment and intellectual property. An FTA would be a more appropriate method to deal with Japanese domestic policies that have an impact on trade -- industrial policy, antimonopoly laws and so on -- than the current emphasis on "fair" trade. And it would help Tokyo and the Japanese people to focus on imports and market liberalization.

- Increased economic benefits. An FTA would remove the remaining tariff barriers and force an evaluation of the remaining nontariff barriers against the yardstick of free trade. It would create new trade, increase economic efficiency and lower consumer prices. It also would encourage U.S. firms to penetrate the Japanese market.

- Support for other U.S. trade objectives. A bilateral arrangement would stimulate talks in the Uruguay Round by "signaling U.S. willingness to pursue bilateral options unless there are meaningful results." It would be a ready second-best alternative if the GATT talks fail. It would stimulate market opening measures by other nations seeking assured access to the U.S. market. And it would provide leverage to deal with potential damage to U.S. commercial interests from the EC's 1992 integration plan.

The report also enumerates the following disadvantages:

- Worsening of the bilateral relationship. A FTA could raise false expectations, increase the political stakes in negotiations and force U.S. negotiators to strike deals when it is not in the best interest of the United States to do so. If the pact were to fail, it could have major negative repercussions on overall U.S.-Japan ties. It may not eliminate the need for U.S. pressure tactics since sensitive political issues can be solved in Japan only at the highest level.

• Failure to produce meaningful market access to Japan. The accord may generate little change in trade because: Japan's tariffs on manufactured goods are already among the world's lowest and Japan retains few quotas or other official barriers to imports; it may not be able to address such things as industrial targeting and the distribution system; and it also may be unable to influence informal problems such as a "buy Japan" mentality. Negotiating the FTA may divert limited U.S. negotiating resources and take a substantial period of time to complete.

• Imposition of economic costs. The pact may force major adjustments by industries such as steel, textiles, cars and agriculture. It could cause a worsening of the bilateral trade imbalance. It could result in trade diversion. Japanese products may become cheaper than similar products from other countries thanks to the lack of duties even when the other foreign producer may in fact be the lower cost supplier. Since the United States would not collect duties on either Japanese imports or the imports for which they substitute, and since the more efficient producer would not gain, an overall economic loss to the United States and the world would accrue.

• Frustration of overall U.S. trade objectives. The pact may stall the GATT process in which the United States and Japan are key players. U.S. participation in more bilateral agreements may weaken the multilateral framework of the GATT. It also may weaken the U.S. hand in multilateral trade talks with other nations that enter into exclusive bilateral trade pacts. It could encourage the EC to adopt a fortress mentality. It also could harm relations with other Asian nations. And it could eliminate the option of bringing multilateral pressure to bear on Japanese trade policies.

Finally, the ITC lists four alternatives to an FTA: developing a series of broad economic understandings; managing the bilateral relationship through numerical goals; developing new institutions to handle bilateral issues; and trying other methods of negotiation or pursuing other goals in trade talks. In sum, the commission sees many theoretical and practical problems in implementing a bilateral FTA and no assurance that it would yield net benefits.

Senator Max Baucus (D, Mont.) actually jumped the gun on the ITC in submitting a comprehensive U.S.-Japan economic accord for congressional consideration August 3 (see JEI Report No. 32B, August 19, 1988). Pointing to the scale of the bilateral trade imbalance, the importance of particular products to economic and national security, and the "disarray" of U.S. trade policy, Mr. Baucus advocated a sweeping change in the bilateral relationship based on four ideas:

• Negotiated bilateral trade targets. "We must pull away from a process-oriented trade policy that attempts to force the rest of the world to accept the U.S. model of a free market, and instead pursue a policy that aims to achieve concrete results," he asserted. Trade targets should both encourage trade and eliminate the imbalance over several years.

• Rules of the road. Discussions on trade practices, such as predatory dumping and Japanese barriers to Third World imports, must be addressed individually.

• Macroeconomic coordination. Mr. Baucus feels that coordination through the Group of Seven major industrialized countries is limited, and his proposal calls for the United States and Japan to form a Group of Two to develop a more sweeping macroeconomic coordination mechanism. The G-2 model could be enlarged to include other industrialized nations, but even if this does not occur the G-2 would help solve many bilateral issues.

• Burdensharing. While the senator admitted that this is "the most difficult part of the U.S.-Japan economic equation," he nonetheless called for increased Japanese security spending to eliminate the "economic disadvantage in relation to Japan" that heavy defense spending imposes on the United States. Not only must Japanese defense and overall foreign aid spending be increased, but Japan must play a major role in solving the Third World debt crisis.

Despite its grand scope, Mr. Baucus's plan devotes little attention to the problem of negotiating and implementing such an agreement. He also suggested that such a pact would not damage the GATT process. Although the legislation stands little chance of passage, it has added fire to the debate.

Japan - Four ministries and one agency have started individually studying the idea of a bilateral FTA and eventually will pool their efforts into a unified position. This final step may be some time in coming, however, as the range of views among ministries is quite diverse.

Even the most optimistic agency, the Ministry of International Trade and Industry, sees many problems and pitfalls in the concept. Vice Minister for External Affairs Shigeo Muraoka described three basic principles of any bilateral FTA. It must promote the world GATT trading system by being nondiscriminatory and open to the rest of the world. It must contribute to the growth of the Pacific community by acting as a nucleus for enhancing interdependence. Finally, it must be a positive factor in building a more mature bilateral relationship. MITI is studying not only a bilateral agreement but a Pacific Basin pact as well and hopes to finish work within two years.

Two other government organizations have established formal advisory bodies. The Ministry of Foreign Affairs group is focusing on the impact of any such agreement on ties with Asian countries and on the Uruguay Round. The political problems that might arise in both Japan and the United States also will be discussed. MOFA has set no deadline for submission of this report. The Economic Planning Agency also is looking into economic impacts, both on the domestic economy and on Japan's trade patterns. EPA hopes to have its study finished within a year.

The Ministry of Agriculture, Forestry and Fisheries and the Finance Ministry have started informal working groups as both feel the FTA idea is too nebulous. MAFF's attitude is not very positive since it clearly wants to defend the country's current level of agricultural self-sufficiency. It is in no hurry to study the issue and scoffs at the idea that Japan can formulate a position within a few years. MOF is looking into the macroeconomic issues, including fiscal and monetary policy coordination and exchange rate policy.

MOFA and EPA also are trying to encourage interagency meetings on the subject but are having difficulty finding enough common interests to set an agenda. MOFA is particularly concerned that a lackadaisical Japanese response could be interpreted by the United States as another example of Japan failing

to live up to its new, larger global responsibilities. Given the gap between MITI and MAFF viewpoints, however, MOFA could have a difficult time generating a timely, unified response.

The Nature of the Beast

Before real progress can be made on either side of the Pacific, the fundamental issue of what exactly would be included in a bilateral agreement must be answered. Until everyone has a better idea of the nature of the beast, the concept will remain a pipe dream. Both the EC's 1992 integration plan and the U.S.-Canada accord are serving as models for what should or should not be included, but the discussion is not limited to the content of these two agreements.

Tariff barriers would be a natural topic. Even though Japan and the United States have relatively low average tariffs, the levies on certain products are still substantial. The approach of the U.S.-Canada pact -- phasing out remaining tariffs over a 10-year period -- has received generally favorable comments. This is viewed as just the start, however, from the U.S. standpoint. The elimination of tariffs is not expected to affect the bilateral trade balance significantly.

Opinion on nontariff barriers is divided, depending on what barriers are to be discussed. Customs user fees, testing and certification requirements, performance requirements, government procurement policies, bidding procedures and so on generally are accepted as fair game for inclusion in an FTA. Cultural differences, tax differentials and business practices are more controversial. Many are tied to the national character and psyche and thus are resistant to change. Such topics also can ignite hostility if the perception of foreign interference in domestic issues is strong.

Trade restraints on items such as cars, steel, textiles, agricultural products and petroleum are particularly thorny problems. It certainly would be odd to negotiate a free trade agreement and maintain controls on these items. However, the political and the economic costs associated with these and other barriers to trade in specific products may be too large to bear all at once. Perhaps a long-term phaseout of managed trade would work, but the political barriers to initiating the process are very high on both sides of the Pacific.

Services surely would be included, especially in the financial area. The United States and Japan already have made progress toward harmonizing and integrating their financial markets, but both must consider broader issues as well. The separation of commercial and investment banking, telecommunications standards and legal services have caused difficulties in the past and remain sensitive topics. Air transport has proven particularly resistant to negotiation (see JEI Report No. 13A, April 1, 1988), and it is unclear if an FTA would help.

Intellectual property may not be included, simply because it is being discussed in other forums. The issue is being handled trilaterally by the United States, Japan and the EC. It also is a part of the Uruguay Round. Bringing it into any FTA talks may be necessary if progress via other means stalls.

Dispute resolution mechanisms are another topic of mutual interest, with the U.S.-Canada agreement serving as the primary model. From the Japanese standpoint, such an institution would lead to more sensible, apolitical solutions. However, the Japanese are leary of investing too much power in any arbitration mechanism for fear of it reaching politically unfeasible decisions.

Tied to this issue is the problem of trade laws. Would an FTA shield Japanese firms from U.S. laws? Or would U.S. laws remain a sword over Japan's head? Understandably, Japanese businessmen and policymakers favor the former interpretation while Americans foresee the latter. The U.S.-Canada pact, for example, would protect Canadian steel, car and food manufacturers from charges of dumping or unfair subsidization. The incentive to negotiate an FTA is sharply reduced if access cannot be guaranteed and if application of trade remedies remains a subjective decision.

Equally vexing are questions about the political practicality of such an agreement. It took Washington and Ottawa only two years to negotiate the U.S.-Canada pact, but no one expects the task to be as quick in the case of Japan. While the United States and Canada have broadly complementary economies and are already highly integrated, the Japan-U.S. relationship is much more competitive. The dislocations from a U.S.-Japan FTA would be much greater and more difficult to deal with if it covers major industries such as motor vehicles and agriculture. Many question whether it is politically possible for either side to negotiate a pact if it would cause too great a disruption.

Factors such as cultural differences, a history of acrimonious trade relations and a lack of trust (compared to U.S.-Canada ties) also would make negotiating a broad, meaningful FTA with Japan a much more difficult proposition. While recent trade agreements have reduced current tensions, the well of amity and trust is shallow in the opinion of many analysts.

Several American observers point out that the United States would automatically be at a disadvantage in negotiating a FTA with Japan because of institutional differences between the organizations that presumably would represent each side. The influence of the U.S. Trade Representative within the U.S. government compares poorly with that of MITI in Tokyo, meaning that the USTR will have to deal not only with the Japanese but also with other U.S. agencies. In terms of human and support resources, the USTR is overmatched. The situation raises questions over whether the United States can forge a unified position, whether the USTR can translate that into a beneficial agreement, and whether Washington can deliver on what the USTR promises.

Even if a pact is negotiated, it is an open question whether it can be approved. Observers point to the recent, sharp turnaround of Canadian sentiment toward the FTA -- which includes concerns such as cultural invasion and independence, whether the level of social welfare and health care will be equalized by economic pressures, and the question of general economic independence -- as a preview of a public campaign that may unfold in the United States or Japan. Rational arguments do not always have the intended effect on voters.

The same may be said of Congress itself. The sometimes irrational responses of some members to the Toshiba Machine Co., Ltd. affair and to rising foreign direct investment in the United States may be mere shadows of Congress' reaction to a U.S.-Japan FTA. The potential for conflict between a Republican president and a Democratically controlled legislature may further reduce the

chance that a bilateral free trade treaty would be approved. It could take a great deal of political capital as well as strong leadership in both countries to obtain legislative approval of an FTA.

Road Blocks or Building Blocks?

Beyond these concrete issues, basic philosophical questions arise about the concept of bilateral free trade agreements. Uppermost in many minds is what impact a U.S.-Japan FTA would have on the Uruguay Round. Arguments that it would promote or retard the process seem equally plausible. Unlike the U.S. accords with Canada and Israel, two relatively small countries economically, an agreement with Japan would involve a substantial portion of global trade and output. Coupled with the EC's 1992 integration plans, would a U.S.-Japan FTA mean the end of the global free trade system and the start of a system based on trading blocks? Those who argue that trading blocks can be a transitional phase to achieve global free trade make no convincing argument on how or why the change would occur. The danger with trading blocks is that they may breed a false sense of complacency. Many Japanese analysts point to the formation of loose trading blocks as one factor contributing to the Great Depression.

Of particular concern is the impact on developing countries that depend heavily on the United States, Japan and Europe for markets. Even a limited amount of trade diversion could prove devastating to small exporting countries. Yet if the FTA led to trade creation, it could lift the developing countries' fortunes as well. Given the complexity of American and Japanese economies, it is not surprising that economists cannot agree on whether trade diversion or creation would dominate; there are simply too many "what ifs." This uncertainty instills a great deal of caution in Japan's approach to an FTA.

One solution to both these concerns is the creation of a Pacific free trade block. By allowing countries to join in stages or participate in free trade in a limited number of goods or services, a Pacific trading block may indeed act as a stepping stone to global free trade. The complexities of negotiating such an agreement are naturally greater. A number of institutions already exist, such as the Pacific Economic Cooperation Conference, that are focusing on expanding Pacific Basin interaction. Whether such institutions can become the framework for a Pacific free trade zone has yet to be examined.

The process of exploring and perhaps negotiating a free trade agreement between Japan and the United States (or other countries) may in itself yield benefits. Dispute settlement institutions may evolve, chronic issues may be resolved and mutual trust improved. The cost of failure, however, is also high. With the anti-FTA parties reportedly in the lead before the November 21 Canadian lower house elections, there already are rumblings south of the border about the adverse consequences should Canada reject the agreement. Not only would the United States be less inclined to cooperate with Canadian requests in the future, but a rejection also may dampen the spirit of GATT members. If two countries with as many common interests and ties as the United States and Canada cannot succeed in reducing barriers in areas such as services and intellectual property, what chances do the disparate participants in the Uruguay Round stand of achieving consensus?

In sum, it appears that the concept of a U.S.-Japan free trade agreement is fraught with perils as well as pearls, not only for the two countries directly involved but for the global economy as well. Fortunately, neither side seems eager to rush into an agreement anytime soon. With careful thought and negotiation, it may be possible to eliminate many of the uncertainties. The process surely will be a long one, but the prize may be worth the risks.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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